



**Investment Office**

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February 17, 2009

**AGENDA ITEM 3a**

**TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE**

- I. SUBJECT:** Discussion of Policy on Leverage
- II. PROGRAM:** Total Fund
- III. RECOMMENDATION:** Information only
- IV. ANALYSIS:**

Background

As discussed in December 2008, Staff is engaged in developing risk metrics on a Fund-wide basis as part of an integrated and holistic approach to risk management beyond the traditional quantitative risk measures such as standard deviation and tracking error. The broad risk categories are identified as follows:

- Market Risk:** Arises from changes in the valuation of securities and is normally captured by measures such as standard deviation, tracking error and Value at Risk (VAR) but should also include concentration risks.
- Credit Risk:** Risk of loss due to the default of a counterparty.
- Liquidity Risk:** Risk of loss due to the inability to sell assets in a timely manner.
- Financial Risk:** Arises from leverage which amplifies the risk and return of underlying assets.
- Operational Risk:** Risk of loss due to a problem in clearing or settlement of securities or derivative contracts.

Staff proposes to address the financial risk identified above through the Leverage Policy. A draft Leverage Policy has been developed and is under review by the Board's consultant and the various asset class units. The other risk factors listed above will be addressed by appropriate amendments to the existing Risk Management Policy after discussion with the Investment Committee in March.

#### Proposed Policy

The noteworthy aspects from the proposed Leverage Policy are as follows:

- A. The use of financial leverage magnifies investment returns both positively and negatively and could increase the volatility of returns. Market illiquidity increases the risk of a leveraged investment particularly under crisis scenarios. Leverage also increases the risk exposure of asset classes and programs beyond the actual allocations. Hence leverage needs to be managed prudently and with specified limits.
- B. The policy provides a framework for identifying, measuring and managing various forms of leverage that currently exist or could potentially exist and provides broad guidelines.
- C. The policy will require that the Asset Allocation and Risk Management Unit provide a quarterly report to the Investment Committee on leverage on a Fund-wide basis.
- D. The policy makes a distinction between non-recourse debt and recourse debt and recommends that recourse debt not be employed except with the specific approval of the Investment Committee. This conflicts with the current Real Estate Policy which allows a certain percentage of recourse debt. From an allocation and risk management point of view, recourse debt creates a contingent increase in allocation to the asset class and should require a cash reserve.
- E. Non-recourse debt is permitted within limits specified in the policies for Private Real Estate, Infrastructure, and Forestland.
- F. The policy guidelines required Global Equity and AIM asset classes to address management of leverage as a risk factor through their respective policies.
- G. Consistent with existing policy, derivative transactions may not be employed to create leverage unless expressly permitted in the respective program policy.
- H. The proposed policy identifies leverage created through the use of derivatives or leverage created by using cash collateral to gain non-cash

like exposure as notional leverage that must have specific limits in the respective program policy. Examples of such notional leverage include:

- 1) Enhanced equity strategy that gains equity exposure through futures and then invests the cash collateral in short-term bonds thus acquiring credit and duration risk in addition to the equity exposure; and,
  - 2) Reinvestment of cash collateral from lending securities in non-cash like securities thus acquiring credit and duration exposure in addition to the exposure in the securities being lent out.
- I. The proposed policy also identifies the “Credit Enhancement Program” as a source of contingent claim that requires an appropriate limit and possibly a cash reserve.

#### **V. STRATEGIC PLAN:**

This item supports Goal VIII to manage the risks and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and, second to minimize and stabilize contributions.

#### **VI. RESULTS/COSTS:**

There are no costs associated with this item.

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